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College Savings Plans: Investment Options, Safety, and Policy Implications

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With recent stock market decline, balances in many college savings (529) plans have also declined. Investment options such as money market funds or FDIC-insured CDs are gaining attention, and questions are being raised about the safety of 529 savings plan investments. This brief provides information on 529 savings plan investment options, safety, and policy implications.

College savings (529) plans vary by state in terms of investment options and investment management or investment policy guidelines. Each state chooses how their investment options are managed by contracting with a single manager or multiple investment management firms. Typically, a 529 savings plan offers accountholders a variety of investment options across several classifications: equity, fixed income, blended funds (a combination of stocks and bonds), guaranteed or principal preservation and bank CD products, and age-based funds (a mix of investments that adjusts according to the prospective student's age).

Age-based funds have been the most popular type of 529 savings plan option. These funds seek to protect the 529 investment from risk as the student gets closer to college age. As of October 2007, about 75% of plans offered such options, with over 50% of 529 plan assets in Vanguard funds and over 70% of 529 plan Fidelity assets allocated to age-based funds. The popularity of age-based funds is their simplicity for investors: the funds automatically adjust over time from more aggressive to conservative, and they are fairly easy to understand (Paikert, 2007).

However, in response to recent stock market declines, more 529 investors have sought safe, conservative options that protect principal (Kim, 2009; Mincer, 2009). Other 529 investors have reallocated to bond or Treasury funds (Kim, 2009). Temporary IRS rule changes now allow account owners to change their investments twice in a year, further encouraging re-allocation.

Growing interest in safer investments is evidenced by new 529 savings plans options and investment patterns. For example:

» The Utah Educational Savings Plan recently introduced an FDIC-insured savings account with no minimum contribution requirement (Kim, 2009).

» Ohio's bank-deposit products have doubled in asset holdings in the last year (Kim, 2009; Mincer, 2009).

» New accounts in Virginia's CollegeWealth 529 bank-products rose 62.5% in December 2008 (Kim, 2009).

» Wisconsin added CD portfolios in October 2008, and over 70% of assets in these CDs were reallocated from existing 529 funds (Kim, 2009).

» The College Savings Bank reports that CD account openings in Arizona and Montana rose 90% in 2008 (Kim, 2009).

Safe 529 investment options are not new. The majority of college savings plans offered a conservative investment option well in advance of the recent stock market decline. Currently, of 84 plans (some states have more than one plan), 51 offer a money market fund, short-term reserve fund, or cash reserves. Twenty-one plans offer some type of guaranteed investment option, and 13 offer Treasury inflation-protected securities (Mincer, 2009). While such "safe" funds are becoming more popular in an economic crisis, not all state 529 savings plans offer these options. The College Savings Initiative proposes federal reforms that would require all states to offer at least one guaranteed or capital preservation option (Newville, Clancy, & O'Brien, 2009).

Investment managers, funds offered, and investment guidelines vary widely from state to state. As would be expected, 529 plans have performed differently both before and during the market crisis. State 529 plans that focus on a diverse array of asset classes and have sensible allocation among stocks, bonds, and cash can be crucial to superior plan performance (Brown, 2009). These investment management principles should be defined and enforced through state investment policies and attentive fiduciary oversight.

This has not always been the case. In the current recession, age-based funds in certain states were particularly harmed due to over-exposure in equities, sometimes for older age groups (Brown, 2009; Zweig, 2009). These negative results were due to misguided (and perhaps misrepresented) investment management decisions, and limited oversight in some of the states.

Some states have created a formal investment policy to govern their 529 savings plans. Among other purposes, an investment policy specifies the long range investment objective of each of the plan's investment options, and sets clear standards for short-term investment monitoring. Such policies and practices can guide boards and administrators who oversee 529 plans in meeting their fiduciary responsibilities to accountholders (Feirstein, et. al., 2009).

Each state should adopt investment policies that assure a range of options and sensible asset allocation for all investment portfolios offered by the plans. Written investment policies could focus on diversification of 529 savings plan investments and provide a mechanism for regular monitoring of investment policies. States should also continue to educate accountholders of the risk and reward characteristics of each investment offered by the plan, via plan documents, marketing materials, and websites.

The larger lesson is that there is an important role for a more active federal 529 policy to establish basic standards for the states regarding investment options and on-going investment oversight. Department of Labor oversight and ERISA rules governing employee benefit plan fiduciaries may serve as a model for 529 plans going forward.

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Learn more about the College Savings Initiative at http://collegesavingsinitiative.org.

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